

RICHARD HUGH BAKER

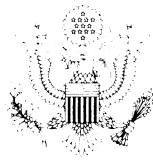
6TH DISTRICT, LOUISIANA

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AND TRADE



Congress of the United States

House of Representatives
Washington, D.C. 20515-1806

April 10, 2003

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The Honorable William H. Donaldson
Chairman
Securities And Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Dear Chairman Donaldson:

I write as a follow up to the recent credit rating agency hearing held by the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises.

I am deeply concerned that this industry is not only dominated by, but effectively limited to, four firms, as a result of the NRSRO designation process that is governed by the Commission staff. It appears that the government has created an oligopoly, eliminating the checks and balances that would serve the public interest in a free market.

I am troubled by the process by which the NRSRO designation is granted and by the potential conflicts of interest that exist under the current structure. Moreover, I question whether the current structure serves the interests of investors and the markets, given the track record of the rating agencies that failed to adequately warn investors of the significant bankruptcies in the recent past.

In my ongoing efforts to restore investor confidence and the strength of our capital markets, I believe it is essential to address what are clearly deficiencies in the rating agency recognition regime created by Commission staff. **To that end, I am requesting the Commission's views on the questions set forth below. Please provide your response no later than June 4, 2003.**

Utility of NRSRO Ratings

1. Do you believe the NRSROs have adequately served the public, in light of this recent history: continuing to rate Enron "investment grade" four days before bankruptcy; California utilities "A-" two weeks before defaulting; WorldCom "investment grade" three months before bankruptcy; and Global Crossing "investment grade" four months before defaulting on loans? We understand that other rating firms, which have not received NRSRO status from the SEC staff, provided investors with more timely

warnings of the financial problems of those issuers. Would greater competition in the credit rating agency business improve the reliability of ratings?

2. I understand that rule 436(g) under the Securities Exchange Act of 1933 shield NRSROs – but not rating agencies without the designation – from prospectus liability. Therefore, isn't it true that NRSROs are not subject to the checks that either competition or the threat of legal accountability would provide?
3. What alternative mechanisms to NRSROs exist to enable investors and regulators to evaluate credit risk? How do market participants and regulators evaluate the creditworthiness of issuers of unrated securities and loan applicants?
4. Professor Lawrence White testified at our hearing that in order to achieve the public policy goal of improving competition and increasing the potential for innovation in the ratings business, "the SEC and other financial regulators should cease delegating their safety judgments to a handful of protected bond raters." He argued that regulators should make the same safety and soundness judgments about bonds that they currently make about loans and other financial assets. One way to do this, he asserted, would be for the SEC to withdraw the NRSRO designation. Should the SEC discontinue the concept of NRSROs? If it were to do so, how should federal regulators, Congress, and the states change regulations and laws related to NRSROs so as to minimize disruption to the marketplace?
5. Alternatively, how might the Commission eliminate the barriers to entry that it has created and foster a competitive environment for this industry? Would competition be adequate to protect the public interest or should regulatory oversight of the agencies' activities be imposed?
6. Commentators have observed that "ratings triggers" in debentures, which can accelerate a debt obligation, may cause rating agencies to be reluctant to downgrade an issuer's rating, for fear the downgrade will trigger a default. Some have advocated barring such ratings triggers. What is the utility of credit ratings if the rating agencies are loathe to provide accurate ratings if those ratings would trigger a default? This reminds us of the Wall Street securities analysts who were reluctant to downgrade a rating on a company that was an investment banking client. What is the Commission's view of the potential impact of such ratings triggers on ratings?
7. How does the development of XBRL, which is expected to facilitate comparison of financial statements, affect the Commission's analysis of

the need for the NRSRO designation?

8. Absent the “NRSRO” status, from a regulatory standpoint, why should the government regulate credit rating agencies’ analyses any differently from how they regulate the work of equity analysts?

Monopoly Power

9. Since the Commission staff has granted NRSRO designation to only four existing firms, two of which control 80% of the market share, it is readily apparent that the normal checks and balances provided by marketplace competition are not present in this industry. In the case of other monopolies regulated by the SEC, statutes or regulations typically impose public-interest obligations and limit the exercise of monopoly pricing power. Isn’t it true that the SEC does not exercise any oversight of the fees charged by the rating agencies to distribute the ratings to the public? In the absence of SEC oversight, what prevents the rating agencies from exercising monopoly power over pricing for ratings distribution?
10. We have heard concerns that at least one rating agency is attempting to more than triple the price it charges to provide its rating to the public, without any changes to the product itself. What could justify tripling the price of access to ratings information without any change in the information provided? Does this not suggest that the rating agencies exercise monopoly power?
11. We have heard concerns regarding “notching” and other monopolistic practices by the rating agencies. Do you share these concerns? What is being done to address these practices?
12. In 1998, the U.S. Department of Justice filed a comment letter to the Commission’s proposed rule relating to NRSROs. The Justice Department expressed several concerns with the Commission’s proposal which, in certain respects, would have formalized the NRSRO recognition process. DOJ stated that the Commission’s “recognition” requirement – i.e., to receive NRSRO designation, a rating organization would have to be nationally recognized as an issuer of credible and reliable ratings – is “likely to create a nearly insurmountable barrier to *de novo* entry into the market for NRSRO services.” Accordingly, DOJ urged the Commission to revise this language to “minimize this potential anticompetitive effect.” We understand that, although this rule was never adopted by the Commission, the “recognition” rule was and continues to be an informal requirement established by Commission staff. Why has the Commission not heeded the recommendation from the Department of Justice?

Fair Disclosure

13. Regulation FD gives NRSROs preferential treatment, permitting these firms to gain access to non-public information and, therefore, to provide that information to their clients. Doesn't this circumvent the purpose of Regulation FD? Has NRSROs' special access to this information improved the accuracy of their ratings? Why should NRSROs, and not other evaluators of credit risk, receive this special regulatory treatment?

SEC Process Regarding NRSRO Status

14. What are the requirements for obtaining NRSRO status? Where are these requirements published? Is the public granted an opportunity to comment upon applications for this status or upon SEC action relating to that status? If not, why?
15. Does the Commission vote upon NRSRO designations? What is the Commission's role in granting this status?
16. Has the Commission ever revoked a rating agency's NRSRO status? Upon what basis would such a determination be made? Does the Commission evaluate NRSRO performance at all?

Conflicts of interest

17. Conflicts of interest in the form of payments from issuers are a major problem in the equity research area. Prior to 1970, rating firms did not receive much compensation from issuers of debt. In light of this development over the past 30 years, have you tried to wean the rating firms away from issuer compensation, or at least strongly consider recognizing those firms that have succeeded in warning investors and are not subject to the conflicts of interest created by issuer compensation?
18. We understand that the NRSROs derive the bulk of their revenues from fees charged to the companies they rate. For instance, last year Moody's Investors Service collected approximately \$800 million of its \$900 million in revenues from such fees. Doesn't this present an obvious conflict of interest? Why shouldn't regulators and the public be just as concerned about this conflict as we have been about the conflicts created by equity analysts' being compensated based on the investment banking business they bring in?
19. How can an NRSRO accurately be called "independent" if it obtains the majority of its compensation from issuers? Isn't this misleading to investors?

20. What requirements, if any, does the Commission impose prior to granting NRSRO status to guard against firms' potentially rewarding high ratings or resisting downgrading in order to retain or increase fee income?
21. Does the provision of consulting and other services by rating agencies to the companies they rate create conflicts of interest that could call into question the reliability of their ratings?

Again, thank you for your attention to this request and I look forward to receiving your reply.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard H. Baker", written in a cursive style.

Richard H. Baker
Chairman, Subcommittee on
Capital Markets, Insurance, and
Government Sponsored Enterprises